Internal Revenue Service
Washington, DC
CC:INTL-0067-88
Br1:BDBurns

date: FEB 29 1988

to: James Clancy
International Special Trial Attorney
Philadelphia, Pennsylvania

from: Branch 1
Associate Chief Counsel (International) CC:INTL:1

subject: Request for Technical Advice - [redacted]

This is in response to your request of January 21, 1988, requesting technical advice in the above-entitled case. We agree with your concern that Rev. Rul. 82-135, 82-1 C.B. 104, is arguably inconsistent with Treas. Reg. 1.482-2(a)(3). Accordingly, we propose to open a project to consider whether Rev. Rul. 82-135 should be clarified or revoked. Pending such reconsideration, we think it would be appropriate to settle your case on the basis proposed by the taxpayer.

ISSUE

Whether Rev. Rul. 82-135 should be applied to require the allocation under section 482 of interest income to a domestic parent corporation which provides short-term, interest-free financing for periods of less than six months to wholly owned foreign subsidiaries in the ordinary course of business, where similar financing is not provided to unrelated corporations engaged in similar transactions with the parent corporation.

FACTS

The taxpayer owns a domestic subsidiary, [redacted], with which it files a consolidated return. [redacted] owns [redacted] foreign subsidiaries which are engaged in the leasing of computer equipment. [redacted] provides various legal and administrative services to its subsidiaries and to unrelated third parties regarding the acquisition of equipment, administration of leases, negotiation of equipment purchases and leasing agreements, reviewing documentation, verifying third-party credit and servicing for existing leases. [redacted] also provides temporary financing to its subsidiaries to fund purchases of equipment until permanent financing can be arranged. Most of these advances are outstanding for less than six months. [redacted] receives substantial fees from its clients for services it provides. However, [redacted] does not receive interest from its subsidiaries regarding the advances, nor do the fees paid by the subsidiaries include any component intended to compensate for interest on the advances.

DISCUSSION

Treas. Reg. 1.482-2(a)(3) contains an exception to the general rule that an arm's length interest rate must be charged on loan transactions between members of a related group. The exception applies to "indebtedness arising in the ordinary course of business out of sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit." If such indebtedness is not evidenced by a written instrument requiring payment of interest, the regulation provides that "the interest period shall not commence until a date six months after the indebtedness arises, or until a later date if the taxpayer is able to demonstrate that either it or others in its industry, as a regular trade practice, permit comparable balances in the case of similar transactions with unrelated parties to remain outstanding for a longer period without charging interest."

On its face, the regulation appears to require interest on related party trade balances only after they have been outstanding for longer than six months. Even then, a longer period may apply if the taxpayer can demonstrate that such practice exists in its industry. The term "arising in the ordinary course of business" appears to relate to the types of transactions in which the indebtedness arises rather than to the question of whether the related party transaction is similar to transactions entered into with unrelated parties. In other words, the requirement seems to be that the indebtedness arise out of a business transaction rather than merely be an advance of funds.

In Rev. Rul. 82-135, two situations were outlined involving exports from Country FC. Under the laws of FC, exports to the United States could be paid for by three methods: (1) advance payments made not more than one year prior to certification for export; (2) by draft against an irrevocable letter of credit within six months after shipment; and (3) by means of a deposit with an authorized foreign exchange bank payable within six months after shipment. In situation 1, the FC manufacturer permitted all of its customers, including its wholly owned U.S. subsidiary, to select from among the three permissable methods of payment. In order to protect itself against the price and currency fluctuations, the subsidiary in situation 1 elected the advance payment method. In situation 2, the foreign manufacturer dictated that its subsidiary utilize the advance payment method even though for liquidity reasons, that method was not in the best interest of the subsidiary. Since the subsidiary in situation 2 was not permitted to elect the method of payment as were the other customers, and the method of payment dictated by the parent was not advantageous to the subsidiary, the ruling held that the advance payment did not arise in the ordinary course of business and did not qualify under Treas. Reg. 1.482-2(a)(3) for the six month interest-free exception.

An examination of the ruling file does not indicate that the drafters focused upon the potential conflict between the language of Treas. Reg. 1.482-2(a)(3) and the interpretation of the phrase "ordinary course of business" being adopted in the ruling. LR-189-84, published in the Federal Register on April 8, 1986, proposes to reduce the interest-free period from six months to sixty days, but does not otherwise change the existing rules regarding qualification for the interest-free period. Finally, as you note in your memorandum, PLR 8110003 is inconsistent with Rev. Rul. 82-135 in that it permitted the six month exception to be utilized in a situation where similar advances were not made to unrelated parties.

Under the circumstances, we think that there is a significant question as to whether Rev. Rul. 82-135 was intended to apply to a situation such as that present in the instant case, where there is no indication of a tax motivated transaction. Furthermore, the ruling may be indefensible in any event based upon the language of the regulation. We propose to initiate a project to reconsider Rev. Rul. 82-135 and in the interim, we think it is appropriate for you to settle your case upon the basis proposed by the taxpayer.

Sincerely,

WILLIAM F. NELSON
Chief Counsel

By: Charles A. Ray
CHARLES A. RAY Acting
Senior Technician Reviewer